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# SOME INTERRELATIONS BETWEEN THE INTERNATIONAL MONETARY FUND AND THE COMMERCIAL POLICY CONVENTION

by

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# Some Interrelations Between The International Monetary Fund and The Commercial Policy Convention

## Introduction

It has been proposed that quantitative import restrictions and exchange control should be permitted temporarily in cases of acute balance of payment difficulties. The question what kind of devices should be permitted has been discussed in a memorandum by Professor Ellis of May 26, 1944. In the present memorandum a few more remarks on that question will be made. But we shall be mainly concerned with the question under what conditions exchange control should be permitted and how balance of payment difficulties should be defined. This is evidently a problem with which the proposed International Monetary Fund is vitally concerned and it is necessary that the proposed Commercial Policy Convention takes cognizance of what the International Fund Agreement provides. It would seem to be advisable to try to influence the Monetary Convention so as to make it more useful for Commercial Policy purposes.

## The Provisions of the International Monetary Fund on Exchange Control and Quotas according to Joint Statement of Experts of April 21, 1944

The Joint Statement of April 21 refers to exchange control in three connections:

(1) It lists as one of the obligations of member countries the following: "Not to impose restrictions on payments for current international transactions with other member countries (other than those involving capital transfers or in accordance with VI, above)[1] or to engage in any discriminatory currency arrangements or multiple currency practices without the approval of the Fund."

It will be observed that exchange control is prohibited except with the approval of the Fund. Presumably the Fund will approve of controls only in case of balance of payments difficulties. But the Joint Statement does not say that permission should be given only in case of balance of payments difficulties nor does it give a definition of such difficulties.

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1 The first exception in parentheses which permits a country to prevent capital transfers, does not directly concern commercial policy, although it should be noted that in case of a persistent tendency of capital flight only an elaborate system of exchange controls can successfully prevent capital transfers. The second exception refers to the "apportionment of scarce currencies" which we discuss under (2) below.

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(2) The next point where the joint statement refers indirectly to exchange control and quotas is in connection with the "apportionment of scarce currencies". Under VI, 6, it says:

> "A decision by the Fund to apportion a scarce currency shall operate as an authorization to a member country, after consultation with the Fund, temporarily to restrict the freedom of exchange operations in the affected currency, and in determining the manner of restricting the demand and rationing the limited supply among its nationals, the member country shall have complete jurisdiction."

This permits not only exchange control but also quotas on imports from the country whose currency has become scarce.

(3) The third point where the Joint Statement refers to exchange control is under "X. Transitional Arrangements". There it is stated that the obligation of each member not to impose exchange restrictions for current transactions remains suspended "until it [the country] is satisfied as to the arrangements at its disposal to facilitate the settlement of the balance of payments differences during the early post-war transition period by means which will not unduly encumber its facilities with the Fund." (X.1)

During the transition each country may maintain its wartime restrictions and "adapt them to changing circumstances." While each country undertakes to remove these restrictions, as soon as possible and while The Fund "may make representations to any member that conditions are favorable to withdrawal of particular restrictions" (X.2) and while it is stated that "not later than three years after coming into force of the Fund any members still retaining any restrictions shall consult with the Fund as to their further retention", (X.2) there is no definite obligation to get rid of all wartime restrictions by a certain date.

## Balance of Payments Difficulties as an Exception to the Rule Prohibiting Quotas and Exchange Control

It would seem that the references to the Joint Statement to exchange control and balance of payments difficulties are not definite enough for purposes of commercial policy.

The best method of coordinating the two conventions in this matter would be to have a specific reference to balance of payment difficulties inserted in the proposed convention on the International Monetary Fund. The Fund will be continuously watching the balance of payments position of all countries. This will be one of its primary duties. Hence it will be the logical organization to make declarations on the existence of balance of payment difficulties. If the provision in section IX, point 3, of the Joint Statement (which was quoted above) could be made more explicit by

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saying that the Fund should give permission to introduce exchange control only in the case it finds that a member is confronted with acute balance of payment difficulties, the commercial policy convention could simply refer to the declaration by the Fund.

The next question concerns the choice of methods (types of control) which should be applied in case a balance of payments difficulty has been declared. Obviously conflicting or overlapping obligations or decisions arising from different international conventions or organizations should be avoided. Hence if the Fund permits the imposition of exchange control, in case of balance of payment difficulties, the Commercial Policy Convention should not prescribe quotas in preference to exchange control as an emergency measure. This is another reason, in addition to those listed by Professor Ellis in his memorandum, for preferring exchange control to quotas.

Furthermore an effort should be made to outlaw altogether certain types of exchange control devices such as bilateral clearings or certain kinds of discriminatory multiple currency devices, so that the Fund would be authorized only to permit those kinds of controls which are indicated in the memorandum by Professor Ellis. The ideal solution would be to insert provisions to that effect into the Fund Agreement.

Suppose, however, that the Fund Agreement cannot be made sufficiently specific. What should be done in the Commercial Policy Convention? This question is important also for the reason that it may happen that there will be countries which are partners to the Commercial Policy Convention without being members of the Fund. In these two cases the declaration that an acute balance of payment difficulty exists should be made by the International Commercial Policy Organization. And again certain types of exchange control devices should be proscribed altogether.

Finally the following question may be discussed: Assuming a specific reference to balance of payments difficulties is made in both conventions; should the term "balance of payments difficulty" be defined more precisely for commercial policy purposes, even if the Fund Agreement refrains from giving a definition and leaves it to the Fund to decide according to criteria which it may find suitable? This would not be advisable, because it could lead to conflicting decisions, if the Fund used other criteria than the definition embodied in the Commercial Policy Convention. An attempt should be made, however, to insert a definition in the Fund Agreement. It would have to be along the line indicated on p. 10 of the Document of October 16, 1943. The criterion of a balance of payments difficulty would be either a loss of international reserves (including credit facilities with the Fund) of a certain magnitude [1] over a

1. This magnitude should be expressed in per cent of the existing stock of the country's reserves or of the country's quota in the Fund. It might also be related to the country's needs as measured by the volume and/or variability of its international trade.

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certain period of time or the fall of the reserve to a certain minimum level or a combination of these two factors.

It has been argued [1] that it would be unwise to tie the hands of the Fund by such a definition, because a balance of payments difficulty may exist, it is alleged, which does not find expression in a loss of gold or foreign balances (or an equivalent inflow of short-term funds). The standard example is the British situation in the later 'twenties after the revaluation and re-stabilization of the Pound Sterling. During this period, Great Britain suffered from balance of payments difficulties, it is said, but there was no continuous loss of gold (or inflow of short-term funds).

The argument can be also stated in terms of a definition of equilibrium exchange rates. In these terms it says: Equilibrium of the exchange rate should not be defined exclusively by the absence of a balance of payments deficit, i.e. of a loss of international reserves. The British currency in the 'twenties was overvalued even though the reserve position was stable. The balance of payment was kept in equilibrium at the overvalued Sterling rate by the low level of economic activity. Unemployment was high and national income and output low; this reduced import demand and prevented an outflow of gold. If economic activity had expanded to the full employment level imports would have risen sharply (and exports fallen) and gold would have flowed out of the country. Then the hidden overvaluation of the currency would have come in the open and Britain would have been forced to introduce exchange control or to devalue the currency. It is proposed, therefore, by the proponents of this view that equilibrium rates of exchange should be defined with respect to full employment situation. The equilibrium rate of exchange is defined as that rate which would keep the balance of payments in equilibrium (i.e. prevent an outflow of gold) in a state of full employment. In other words what matters is the state of the prospective balance of payments under full employment conditions and not the state of the <u>actual</u> balance of payments.

The implication of the foregoing argument for the problems on hand is this: It would be unwise to limit the permission to introduce exchange control (or to vary the exchange rate) to the case where the actual balance of payments shows a deficit. For that might prevent countries which are in similar position as Great Britain in the 'twenties to embark on expansionary policies designed to raise the level of employment. If in the 'twenties Britain had not been afraid of losing gold, she would or at least could have increased employment and economic activity by expansionary measures.[2] The Fund should be given a free hand to weigh the whole situation, not only the state of the actual balance of payments, but also its prospective changes.

1 In oral discussion. We know of no references to published material.

2 It can, of course, be argued that Great Britain committed the error of revaluing the Pound to its prewar level. But a similar situation could arise without an actual appreciation.

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Our position with respect to this whole problem is this: We believe that the permission to use exchange control to overcome a balance of payments difficulty should be given very sparingly. It cannot be denied that situations like the one in which Great Britain is supposed to have been in the 1920's are possible. But usually the diagnosis of a current and still more of a prospective situation is not so easy as it appears <u>ex post</u>. We cannot always tell with certainty what will happen under full employment or if certain expansionary policies are applied. Therefore there is a real danger that if no strictly objective criteria are used, it will be too easy for countries to claim that they need exchange control, because they are facing balance of payments difficulties. Would it not be unwise to rely simply on the wisdom and courage to resist pressure of the managers of the Fund? It would probably save the Fund much trouble, if clear, objective criteria were formulated.

Moreover it seems to us that no harm will be done, if the Fund is instructed to permit exchange control only if an actual balance of payments deficit has arisen, i.e. if the country in question looses reserves at a certain rate for a specified period of time or if the reserve has fallen to a dangerously low level. If a country has a sufficient buffer of liquid reserves, what harm can it do to wait for awhile and see how the balance of payments develops? Suppose the British in the 'twenties had decided to embark on a spending policy or some other program of stimulating activity and employment. Suppose that policy would have produced a balance of payments deficit and they would have been forced to depreciate the Pound or to introduce exchange control. Would their policy of expansion been frustrated, if they had been compelled to wait with the devaluation [1] or introduction of exchange control until after some gold had left the country? It is difficult to see that it would have made any difference, especially if we assume the existence of controls on speculative capital movements (capital flight). What is the use of a buffer of liquid reserves (gold and foreign exchange and credit facilities with an International Fund), if it is not used to fill a deficit in the balance of payments until it has been more clearly established that the disequilibrium is serious enough to warrant drastic steps such as the introduction of exchange control or devaluation of the currency? It need hardly be emphasized that it is not necessary that reserves should be allowed to be dangerously depleted before corrective steps are taken. But objective criteria for the existence of a balance of payments difficulty seem to be necessary.

## <u>The Scarce Currency Provisions of the Fund</u>

If the scarce currency provision of the Joint Statement as quoted above is incorporated into the Monetary Fund Agreement, the Commercial Policy

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[1] It is true that a policy which does not attempt to stimulate economic activity by measures which increase domestic demand (public works, tax remission, subsidies to private investment, etc.), but by pushing exports and restricting imports, through exchange depreciation (not forced upon the country by a prior deficit in the balance of payments) would be prevented by the proposed rules. But we take it for granted that it is one of the purposes of the International Monetary Fund to outlaw precisely that kind of begger-my-neighbor policy.

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Convention will have to take cognizance of the fact, that any kind of restrictions on imports from countries whose currencies have been declared scarce by the Fund can be imposed by all other member countries. This is a rather far-reaching provision and it may be advisable to have it modified. Member countries should not be given complete freedom as to how to restrict demand for scarce currencies. Certain objectionable devices might be prohibited or members be given the choice between certain approved methods.

The obvious solution would be to make the same choice as in the case of balance of payments difficulties. If in case of balance of payments difficulties exchange control is permitted, but quotas are prohibited, the same rule could be applied in case of a scarce currency. After all a scarcity of a currency really implies balance of payments difficulties of other countries.

Another question may be raised in this connection. According to the wording of the Joint Statement the criterion of "scarcity" is that the Fund is in danger of exhausting its supply of the particular currency. That need not imply that all countries are short of it. Some countries may be still well supplied with the scarce currency (or with gold). This raises the question whether it would not be advisable to change the relevant provisions and to grant the right to impose restrictions on dealings in the "scarce" currency or on imports from the scarce-currency country not to all members but only to those countries that actually have exhausted their stock of the scarce currency of of gold.

The present provisions of the Joint Statement may conceivably lead to unnecessarily widespread controls. What the experts had undoubtedly in mind, when they drafted the scarce-currency provisions was the now so widely held belief that a scarcity of dollars is bound to arise after the war. If that actually happens, if the American balance of payments on current account is going to show a strong tendency to be favorable and if this cannot be corrected or offset by (a) maintaining a high level of activity and employment in the United States, (b) reducing import restrictions in the United States, (c) exporting long-term capital from the United States or (d) appreciating the dollar -- under all these assumptions restrictions on imports from the United States, applied by all other countries, may be a good solution. A general discrimination against American exports would bring home to the United States the necessity or desirability of taking steps to correct the disequilibrium in the balance of payments by liberalizing import restrictions, appreciating the currency or by increasing import demand by expansionary monetary and fiscal policies. Granted that the solution of the problem as outlined may be desirable, it must still be asked whether the provisions in the Joint Statement would not allow the imposition of controls in less legitimate cases than the one envisaged above.

Suppose, for example, that many countries make it a practice to draw as much as possible on the Fund for dollars before they use their own resources outside the Fund. Then the Fund may exhaust its dollar holdings at an early date when the supply of gold and dollars is still plentiful in most countries. Might it not be too early in that case to permit everybody to impose restrictions against American exports? If the Fund disposed over a large part of the world's dollar resources, the fact that the Fund has lost most of its dollars may be taken as an indication that the American balance

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of payments was favorable due to a deep-seated disequilibrium so that drastic steps have to be taken.[1] But if the Fund's supply of dollars was only a fraction of the total supply, its exhaustion cannot be taken with the same confidence as a symptom that things are fundamentally wrong. Would it not be better to require a separate decision of the Fund, whether everybody should be authorized to impose restrictions on a currency which has become scarce in the Fund, rather than to say, as it is said in the Joint Statement, that "a decision by the Fund to apportion a scarce currency shall [automatically] operate as an authorization" to all members to impose restrictions? If a separate authorization by the Fund were required, the Fund could try to distinguish between cases where the scarcity of a currency in the Fund is symptomatic of a general scarcity of that currency and cases where that conclusion is not, or not yet, warranted. Before authorizing everybody to restrict dealings in the scarce currency the Fund would consider evidence other than the fact that the Fund has depleted its supply of the currency in question; for example gold movements or shifts of dollar balances outside the Fund would be an important factor which ought to be taken into consideration. Moreover, if the Fund came to the conclusion that, say, the American balance of payments was seriously disequilibrated, it may at first propose other measures than the universal authorization to everybody to impose restrictions on the dollar.

The scarce currency provision as it stands now with its automatic authorization to impose controls may conceivably so operate as to impede multilateral trade. Suppose the Dollar becomes scarce in the Fund; countries like Great Britain which habitually have an unfavorable trade balance with the United States and acquire their dollars through export balances with the tropics are short of dollars (and of gold); but they still have balances with other countries where the dollar is not yet short. Normally Great Britain would acquire dollars in these countries; this is a part of the multilateral trading system.[2] Under the scarce currency provision this multilateral settlement may be interrupted, because those countries are authorized to put the dollar under control; that is they may refuse to sell dollars to Great Britain. Suppose, for example, Great Britain has Argentinian pesos; Argentina has dollar balances. Now Argentina can refuse to sell dollars to Great Britain. She may have an incentive for doing that, because she may hope that Great Britain, if she cannot buy dollars with her pesos, may spend them on Argentinian goods. This would constitute a bilateral distortion of trade to the benefit of Argentina.

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1 Those steps may be other ones than the imposition of direct control. The Fund would presumably discuss those possibilities in the report which it is required to issue under Section VI.I. of the Joint Statement.

2 See The Network of World Trade; League of Nations for a detailed description of multilateral settlement.

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It is difficult to foresee how real the danger is that such will be the outcome.[1] But it is certainly possible. If, as proposed above, the provisions were changed to the effect that the authorization to impose restrictions on scarce currencies was not automatic but depended on a separate decision of the Fund, the danger that the pattern of multilateral trade be disturbed, would be reduced if not removed.

## The Transitional Provisions of the Fund

The provisions of the Joint Statement concerning the removal of wartime restrictions are not stringent and definite. Any country can keep its wartime restrictions indefinitely under these provisions. It is true the Fund can make representation, and not later than three years after coming into force of the Fund any country has to consult with the Fund, if it wants to retain restrictions. But there is no definite obligation to remove the restrictions and no sanctions, if a country does not respond to the representations of the Fund.

It may be futile to ask now for an ironclad obligation to remove all quantitative restrictions by a certain specified date. But it would be highly desirable, if a more definite obligation could be written into Monetary Fund or the Commercial Policy Convention.

From a formal, administrative and procedural point of view it will be easier in this case than in the earlier ones to avoid conflicts between the provisions of the Fund Agreement and the Commercial Policy Convention. Even if the Fund Agreement refrained from making more precise transitional provisions than the Joint Statement, the Commercial Policy Conference would be entirely free to write more stringent provisions into its Convention if it sees a chance of doing so successfully. Once a country has abolished its wartime restrictions, it is no longer free, under the Fund Agreement, to re-introduce them without approval of the Fund. It follows that the Commercial Policy Convention can go farther than the Fund Agreement in stipulating the abolition of wartime controls without risking a conflict with the provisions of the Fund.

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1 The Joint Statement contains the following provisions: Under III.4. "the Fund will be entitled, with a view to preventing a particular member's currency from becoming scarce (a) to borrow its currency from a member country, (b) to offer gold to a member country in exchange for its currency". Under III.7.b. the Fund shall insist that half of its sales of foreign exchange be paid for in gold, provided and so long as, the gold reserve of the buying member exceeds its quota.

It is true that these provisions will lessen the danger (a) that currencies become scarce and (b) that the scarcity of a currency in the Fund, if it arises, does not reflect a general scarcity. But nobody can tell whether these safeguards will be sufficient.

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It is, however, much more difficult to formulate objective criteria which should indicate, whether wartime restrictions can be removed than criteria which will tell whether the introduction of controls should be permitted after a free exchange system has been in operation for some time. In the latter case the existence of a balance of payments deficit (i.e. the loss of international reserves) can be used as a criterion.[1] For the abolition of controls the absence of gold losses or even the fact that a country has been able to accumulate substantial reserves are necessary but hardly sufficient criteria. Several other conditions must be fulfilled too. One condition is, of course, the choice of an appropriate exchange rate. As a rule, the removal of exchange restrictions will necessitate a devaluation of the currency. Apart from such a wholesale adjustment of prices within a country and the outside (that is what a devaluating amounts to), the impact of a withdrawal of restrictions (of exchange restrictions as well as quotas) will have to be cushioned in many cases by an increase of tariff duties or the quantitative controls replaced by (higher) duties. Domestic rationing, allocation and price control will have to be removed or at least thoroughly adjusted when international trade is released from the shackles of exchange control.

It will be hardly possible to set down in advance in a clear-cut formula all these conditions as objective criteria for the removal of wartime restrictions. All that can be done is to give power to the international bodies, the Fund or the International Commercial Policy Organization, to work out the details with each country and to instruct them to pay attention to all these factors. A date may be set when, at the latest, such parleys between the Fund and each country should be started and when they should be finished. It might be stipulated that after a certain later date restrictions can be retained only with the approval of the Fund and it could be stated that a country which does not comply with the Fund's recommendations within a reasonable period of time will be denied credit facilities with the Fund which it otherwise would enjoy.

1 This is at least a technically possible position, notwithstanding the fact that some people may argue that it would be advisable to take other factors also into consideration -- factors which throw light on prospective changes in the balance of payments.

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